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OF
COMMERCE

Testimony of the Michigan Chamber of Commerce
Before the House Tax Policy Committee
Wednesday, March 21, 2007
Presented by
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Good morning Representatives, on behalf of the Michigan Chamber of Commerce thank you for the opportunity to provide comments to you this morning in regards to House Bills 4367.

The Michigan Chamber appreciates the Governor's effort to put her ideas for a tax replacement proposal for the Single Business Tax (SBT), and personal property tax (ppt) relief in bill form. As you know, the Michigan Chamber has also proposed a replacement plan, and based on our own experience we know what a daunting task this is.

Let me also say, that while we may not necessarily support this proposal as written, the good news is that there are a number of common features between both the plan the Governor has developed and the plan developed by our members; namely using a business income tax, a gross receipts tax, and providing some personal property tax relief.

Having said that, we have identified a number of areas of significant concern to our members and I will focus my comments on those aspects that are particularly troubling to the Michigan Chamber.

As you know the Governor's proposal uses a 3-pronged tax base approach to replacement of the SBT and ppt relief; business income, gross receipts and assets. We too, have called for using an income and gross receipts approach. But after 30 years of having a unique, one-of-kind tax that no other state has....one of our goals is to steer clear of another unique, one-of-kind tax, which no other state has, that turns out to be a litigation magnet. Yet, the "asset" tax portion of this plan is unlike any other tax in any other state, with no state-level model standards, is un-tested in court and -we fear – pushes the envelope. For these reasons we believe the compliance and litigation costs will be significant. Furthermore, we believe an assets tax would discourage investment by sending a message that companies should not keep property in the state because it will get taxed multiple times. And finally, like the SBT, we feel it would provide Michigan with the dubious honor of having a unique tax that is not found in any other state.

Second, the Governor's plan contains a "fallback" provision in the event certain portions of the plan are found unconstitutional. Michigan should have a tax that is constitutional so no fall back tax is needed. If the Michigan Business Tax is determined to be subject to PL 86-272 (which governs when a state can or cannot subject a company to income tax), or if the application of the apportionment provisions to the assets or income components of the tax base are deemed unconstitutional, the tax becomes a gross receipts tax imposed at a higher rate of 0.375%. Courts have ***already*** ruled that it is unconstitutional to tax property (in this case assets) which is located out-of-state, based on sales made in Michigan.

We believe that the Administration's plan is potentially unconstitutional on a few other fronts as well.

Many courts have ruled that a state cannot tax the income of a company who is merely soliciting sales in a state. In this case, because the income tax is weighted by 15 and the tax base (assets, gross receipts, income) is intertwined, the courts could view this as an unconstitutional tax on the income of a company who is merely soliciting sales in Michigan.

A taxpayer's tax base is apportioned based on a 100% sales factor unless a taxpayer has no sales in Michigan. In *that* case the taxpayer is required to use a two-factor formula based on payroll and property. If every state taxed all companies based on sales in the state but also taxed those companies with no sales in the state based on property and payroll, companies would inevitably be taxed on more than 100% of their income. This requirement…to use property and payroll factors – if the company has no Michigan sales – violates constitutional requirements for fair apportionment.

One of the things our members are seeking is predictability. We also believe the state wants to know what to expect in terms of tax revenues, and should try to avoid costly litigation that unnecessarily wastes taxpayer dollars. Unfortunately this proposal openly admits that it may not be upheld in court. Why would we, as a state, knowingly go forward with a tax that is clearly questionable on the face of it! We urge the Michigan Legislature to take the time needed to pursue a tax replacement that is on solid footing right from the beginning.

Third, while we share the goal of providing some amount of ppt relief, we feel HB 4367 falls short in that it doesn't provide that relief to *all* job providers. All Michigan job providers have the burden of paying personal property taxes, and therefore we believe all should benefit.

The current gross receipts definition from our perspective is overly broad and open-ended. This definition as provided is a problematic SBT legacy definition that has had its share of interpretative problems. New Michigan tax legislation should not simply carryover troublesome SBT definitions or other provisions. We really encourage you to take the guesswork (and quite frankly the hostility) out of determining gross receipts, by taking a more specific and defined approach rather than the more open-ended approach we find in the current SBT law.

The current "law of the land" for determining when a company is subject to tax in a state is a "physical presence" standard. This is embodied in federal PL 86-272 which establishes the threshold for income tax at *more than solicitation of sales,* and the courts (in particular in *Quill vs. North Dakota*) have ruled that a state can only expect a company to remit sales/use taxes if they have a *physical presence* in the state. This standard is further embodied in the current Michigan Department of Treasury's Revenue Administrative Bulletin 98-1, a standard which the Michigan Chamber has embraced in our own tax replacement proposal.

Unfortunately, the administration has deleted the words "within this state" from the definition of Business activity. To us this indicates that the Department is moving to a problematic approach of using an "economic" presence standard, and the implication of this is to bring more taxpayers into the tax base. However, there are *no* existing clear rules (nationwide) about what constitutes "economically present." We believe this effort to "push the envelope" will result in costly litigation against the state.

Which brings me to the next point which is very much related. One of the reasons the SBT itself was a litigation magnet for years was that is was "unique" and not an income tax (with the defined taxing standards mentioned earlier.) One of the things an out-of-state business will be looking for (when determining if they will conduct business in Michigan) is a clear understanding of when they are expected to start paying tax (do they have nexus?) Currently in this bill there is no clearly defined nexus standard. This is imperative in order to avoid uncertainty and litigation. The Administration is seeking to impose an economic presence nexus standard in HB 4386 (the so-called affiliate nexus standard in another bill HB 4386.) Under this standard a company is required to pay tax merely because it shares a business plan, trademark or tradename with a commonly owned company. This standard will cause years of litigation.

The "sourcing" (where/in what jurisdiction is something taxable) of services and intangibles to the state has long been a problem. HB 4367 continues the practice of using a "cost of performance" rule that says that services and intangibles will be sourced based on whether a greater proportion of the activity is performed in Michigan versus another state. This is an "all or nothing rule"...that has the perverse effect of encouraging tax planning. In other words – why wouldn't someone perform 51% of their services in a state with more favorable tax treatment? A taxpayer that performs 49% of its services in Michigan pays no tax. This is not a good policy for the state of Michigan and the more appropriate approach would be a destination standard similar to the sourcing of tangible personal property so that each state gets a proportionate share of revenue.

Also included is a provision that very much *hurts* Michigan businesses by forcing Michigan companies to "throw-back" into their tax base calculation, sales that are not taxable in other states. The fact is...these same sales are not taxable in Michigan! The fact that another state also doesn't tax these

sales shouldn't doesn't make them taxable in Michigan. This will hurt sellers of tangible personal property that have inventory shipped from Michigan, especially Michigan based manufacturers.

The Department has, in the past, taken the approach that a "casual transaction" (as it relates to whether an activity is taxable or not) doesn't really mean anything. Under HB 4367 a casual transaction would include, for example, an individual's sale of investment assets resulting in more than $350,000 of gross receipts. But, the courts have disagreed. In *Manske, et al v Department of Treasury,* 265 Mich App 455, 458 (2005), the Michigan Court of Appeals held that a partnership's one-time liquidation of its business constituted a casual transaction. The Administration's attempt at re-defining, that transactions that occur "in connection" with regular business activity should be taxable is vague, open-ended, a hidden tax increase and is an attempt at undoing a court case the Department lost. Moreover, it is an attempt to codify a practice that they are currently undertaking in audit, but for which they have no authority under current law to do.

While unitary filing may be a laudable method to limit tax planning, the proposal in the Michigan Business Tax is too vague to provide taxpayers any understanding to the requirements being imposed. The definition of a unitary group is vague…requiring only a flow of value. A combined unitary filing is required for all U.S. members of a unitary group. A common parent of an affiliated group may make an election (revocable only with Department approval) to file on a combined basis for each person regardless of whether a person is unitary. The election provision however does not specify whether it is worldwide or waters edge. Absent specificity, the election appears to be worldwide. Furthermore, the provision does not specify how members of a unitary group are treated when members have different tax bases (e.g., insurance company and related insurance agency) or apportionment methods (e.g., transportation company and manufacturer). In sum there are many unanswered questions in this area.

In closing, again we appreciate the effort at proposing an alternative to the SBT and providing ppt relief. We also appreciate the Chair's willingness to begin looking at these plans in detail. While we know you will look at these ideas thoughtfully, we also encourage you to be expeditious – we agree with the State Treasurer that taxpayers…and the Department need at least 6 months to prepare for a new tax system. I believe we all share the same goal of finding a replacement that is pro-jobs, pro-growth, and an improvement over the SBT.

The Michigan Chamber is a statewide business organization which represents nearly 6,700 employers, trade associations and local chambers of commerce. The Michigan Chamber was established in 1959 to be an advocate for Michigan's job providers in the legislative, political and legal process.